18 Casualty and Theft Losses and Involuntary Conversions

The tax treatment of an unreimbursed casualty or theft loss depends on the purpose for which you held the damaged, destroyed, or stolen property. A loss of property held for—

- *Personal purposes* is deducted as an itemized deduction on Schedule A (Line 19). Each loss to personal-use property must be reduced by $100; *see* ¶18.11. The loss also is subject to the 10% adjusted gross income floor (¶18.11) and the sudden events tests of ¶18.5. Personal residences, cars, jewelry, and clothing are examples of property held for personal use.

  The itemized deduction claimed for personal use property is not subject to the 3% reduction computation; *see* ¶13.8.

- *Income-producing purposes*, such as negotiable securities, is deducted on Schedule A (Line 22). The loss deduction is subject to the 2% AGI floor. It is not subject to the $100 and 10% adjusted gross income floors, or the sudden event test.

  The 3% reduction does apply to a loss deduction for income-producing property claimed on Line 22 of Schedule A.

- *Business or rental purposes* is claimed as a loss on Form 4797. It is not subject to any floor or the sudden event test.

Use Form 4684 to determine the tax treatment of a casualty or theft. It has been designed to direct you to the proper method of treating the casualty or theft, and to the schedule for reporting your loss, or gain if compensation for your loss exceeded the basis of the property. If you suffer more than one casualty or theft in 1996, use separate Forms 4684 to figure the loss for each event.

If you have realized a gain, you may defer tax by replacing or repairing the property; *see* ¶18.18.

Appraisal fees and other incidental costs, such as taking photos to establish the amount of the loss, are claimed as a miscellaneous itemized deduction on Line 22 of Schedule A.

¶18.1 When To Deduct a Casualty or Theft Loss

Generally, you deduct a casualty loss in the year the casualty occurs, regardless of when you repair or replace damaged or destroyed property. But say a casualty occurs in one year and you do not discover the damage until a later year, or you know damage has been inflicted, but you do not know the full extent of the loss because you expect reimbursement in a later year. Here is what to do:

If you reasonably expect reimbursement in a later year. You should deduct in the year the casualty occurred only that part of your loss (after applying the personal property floors of ¶18.11) for which you do not expect reimbursement. For example, if you expect a full insurance recovery in 1997 for a 1996 loss, you would take no deduction on your 1996 return.

If you do not expect any reimbursement and deduct a loss in 1996, but you receive insurance or other reimbursement in 1997, the reimbursement is taxable in 1997 to the extent that the 1996 deduction gave you a tax benefit by reducing your 1996 taxable income; *see* ¶12.8. You may not amend your 1996 tax return.

EXAMPLE

In 1969, Hurricane Camille destroyed oceanfront real estate owned jointly by two brothers. The buildings were insured under two policies which included wind damage but not losses resulting from floods, tidal waves, or water. The insurers, claiming the tidal wave had caused the destruction, denied their claim. The brothers consulted an attorney about the possibility of suit against the insurance companies, but there seemed little likelihood of recovery, so they deducted their shares of the casualty loss in 1969. However, in January 1970, the adjusters of both companies changed their decisions, reimbursing the brothers for more than two-thirds of their loss. One of the brothers filed an amended 1969 tax return, reducing the previously reported casualty loss.

The IRS claimed that the insurance recovery is taxable in the year of receipt, 1970, to the extent that the prior deduction reduced 1969 income. The brother claimed that he made an error in claiming the deduction in 1969 because he had a reasonable prospect of reimbursement. Thus it was proper to reduce the deduction by the reimbursement on an amended return.

The Tax Court disagreed. Tax liability is based on facts as they exist at the end of each year. A recovery in a later tax year does not prove that a reasonable prospect of recovery existed in the earlier year. Amendments to previously filed tax returns may be made only to correct mathematical errors or miscalculations, not to rearrange facts and readjust income for two years.

If your reimbursement is less than you expected. Assume you took no loss deduction in 1996 because you expected to recover your entire loss in 1997—but the insurance company refuses to pay your claim. When do you deduct your loss? You deduct your loss in the year you find that you have no reasonable prospect of recovery. For example, you sue the company in 1997, with a reasonable prospect of winning your claim. However, in 1998, a court rules against you. You deduct your loss in 1998, subject to the personal property floors of ¶18.11.

If you, as lessee, are liable to the lessor for damage to property, you may deduct the loss in the year you pay the lessor.

If you do not discover the loss until a later year. In this case, IRS regulations do not specifically allow a deduction for the loss in the year it is discovered, but court decisions have. In one case, an unseasonable blizzard damaged a windbreak planted to protect a house, buildings, and livestock. The damage to the evergreens did not become apparent until the next year, when about half of the trees died and the others were of little value. The court held that the loss occurred in the later year. In another case, hurricane damage did not become apparent for two years. The Tax Court allowed the deduction in the later year. Where drought damage occurs, *see* ¶18.5.

If your loss is in a federal disaster area. If your property is damaged in an area eligible for federal disaster assistance, you have a choice of years for which the loss may be claimed; *see* ¶18.2.

If reimbursements exceed your adjusted basis for the property. Receiving reimbursements in excess of adjusted basis results in a gain that you must report on your return unless you acquire qualifying replacement property and elect to defer the gain; *see* ¶18.18.

If a loss deduction was claimed in a prior year, you must report the reimbursement as income to the extent the prior deduction reduced your taxable income in the year claimed; *see* ¶12.8.

¶18.2 Disaster Losses

If you suffer a loss from a disaster in an area declared by the President as warranting federal assistance, you may deduct the loss either on the return for the year of the loss or on the return of the prior tax year. *See* ¶18.12 for figuring the deductible loss.

You may elect to claim the deduction on a tax return for the previous year any time on or before the *later* of (1) the due date (without extensions) of the return for the year of the disaster; or (2) the due date considering any extension for filing the return for the prior tax year. In the case of a 1996 disaster loss claimed on a 1995 return, you generally have until April 15, 1997, to amend a 1995 tax return to claim a disaster loss occurring during 1996. In the case of a 1997 disaster loss claimed on a 1996 return, you generally have until April 15, 1998, to amend a 1996 tax return to claim a disaster loss occurring during 1997.

You make an election for the prior year in a signed statement attached to your return (original or amended) or refund claim. List the date of the disaster and where the property was located (city, town, county, and state). To amend a filed return for the prior year, use Form 1040X. Consider making the election if the deduction on the return of the prior year gives a greater tax reduction than if claimed on the return for the year in which the loss occurred or you want a refund of all or part of the tax paid for the prior year.

Revoking your decision. After making your election of which year to claim the disaster loss, you have 90 days in which to revoke it. After the 90-day period, the election becomes irrevocable. However, where an early election is made, you have until the due date for filing your return for the year of the disaster to change your election. Your revocation of an election is not effective unless you repay any credit or refund resulting from the election within the revocation period. A revocation made before you receive a refund will not be effective unless you repay the refund within 30 days after you receive it.

Homeowners forced to relocate. If you were forced to relocate or demolish your home in a disaster area, you may be able to claim a loss even though the damage, such as from erosion, does not meet the sudden event test of ¶18.5. For example, after a severe storm, there is danger to a group of homes from nearby mudslides. State officials order homeowners to evacuate and relocate their homes. Disaster loss treatment is allowed provided: (1) the President has determined that the area warrants federal disaster relief; (2) within 120 days of the President's order, you are ordered by the state or local government to demolish or relocate your residence; and (3) the home was rendered unsafe by the erosion or other disaster. The law applies to vacation homes and rental properties, as well as to principal residences.

If these tests are met, the loss in value to your home is treated as a disaster loss so that you may elect to deduct the loss either in the year the demolition or relocation order is made or in the prior taxable year.

Fiscal year. If you are on a fiscal year, an election may be made for disaster losses occurring after the close of a fiscal year on the return for that year. For example, if your fiscal year ends June 30, and you suffer a disaster loss anytime between July 1, 1996, and June 30, 1997, you may elect to deduct it on your return for the fiscal year ending June 30, 1996.

Disaster relief grants and loans. Cancellation of part of a disaster loan under the Disaster Relief Act is treated as a reimbursement that reduces your loss; *see* ¶18.12. Grants to disaster victims under the Disaster Relief Act are not taxable, but the grant is considered a reimbursement reducing your deductible loss.

INSURANCE PROCEEDS FOR DAMAGED PRINCIPAL RESIDENCE

Generally, you have a taxable gain if you receive insurance proceeds in excess of your adjusted basis for your home or its contents. However, under a special rule, if your principal residence (whether owned or rented) is damaged by a Presidentially declared disaster, you pay no tax on gain from insurance proceeds received for *unscheduled* personal property damaged or destroyed in the home. Personal property is *unscheduled* if it is not separately listed on a schedule or rider to the basic policy.

In addition, insurance proceeds received for the home itself or for *scheduled* property are treated as received for a single item of property. Gain on this combined insurance pool may be deferred by investing in replacement property that is similar or related in service or use to either the damaged residence or its contents. If the cost of a new principal residence and/or contents equals or exceeds the combined insurance pool, you may elect to defer any gain attributable to the insurance recovery; *see* ¶18.20 for making the election. The deferred gain reduces your basis in the replacement property. The period for purchasing replacement property ends four years after the end of the first tax year in which any part of your gain is realized. If the cost of the replacement property is less than the combined insurance pool, your gain is taxed to the extent of the unspent reimbursement.

EXAMPLES

1. Your home was destroyed by a flood in 1996. The county in which your home was located was declared a disaster area. You received insurance proceeds in 1996 as follows: $200,000 for the home; $25,000 for unscheduled personal property in the home; $10,000 for a stamp collection and $5,000 for jewelry which were kept in your home and were scheduled property on your insurance policy.

   The $25,000 received for the unscheduled personal property is not taxed.

   You can choose to postpone reporting any gain on the remaining proceeds of $215,000 if you acquire property similar or related in service or use to your home, jewelry, or stamp collection. If you use all of the proceeds to purchase a new principal residence, you may postpone all of your gain even if you do not purchase any jewelry or stamps. As long as the total cost of replacement property is at least $215,000, you may defer all of the gain, regardless of how the reinvestment is divided between the residence and household contents. New household contents may be either scheduled or unscheduled property.

   If you invest less than $215,000, you must include the gain in income to the extent the proceeds exceed the amount used for property similar to your home, jewelry, or stamp collection.

   To postpone gain, you must purchase the replacement property before 2000. The replacement period ends December 31, 2000, four years after the close of the first year (1996) in which any gain was realized. Your basis in the replacement property is cost *minus* the amount of any postponed gain.

2. You rent an apartment as your principal residence. Your apartment and its contents were completely destroyed by a hurricane in 1996; the county in which your apartment was located was declared a disaster area. You received insurance proceeds of $17,000 for unscheduled personal property in your apartment. The proceeds are not taxable.

Sale of land following disaster. If your principal residence is destroyed in a Presidentially declared disaster, and you decide to relocate elsewhere and sell the underlying land, the IRS treats the sale and the destruction as a single involuntary conversion. The land

sale proceeds are combined with your insurance recovery for purposes of figuring deferrable gain when a replacement residence is purchased. All of the gain resulting from the insurance recovery may be deferred if a new principal residence is purchased within the four-year replacement period and it costs at least as much as the combined insurance and sales proceeds.

The same gain deferral rule applies if a Presidentially declared disaster destroys a second residence such as a vacation home that qualifies for a mortgage interest deduction (¶15.1), but in that case the replacement period is two years (¶18.21) instead of four years.

The two-year replacement period also applies where the damage is to a principal residence but a Presidential disaster declaration is not made.

EXAMPLE

Your principal residence is destroyed in 1996 by a tornado that is declared a disaster by the President. You receive in 1996 insurance proceeds of $120,000. You decide not to rebuild and in 1997, you sell the underlying land for $10,000.

If your basis for the property (land and house) was $100,000, your gain from the insurance recovery is $20,000 ($120,000 insurance – $100,000 basis). The $100,000 reduces your basis in the property to zero, so on the later sale of the land there is a $10,000 gain that could not be deferred if the land sale was treated separately. However, since the sale of the land is treated by the IRS as part of the original involuntary conversion occurring when the home was destroyed, the overall gain of $30,000 is eligible for deferral if you buy a qualifying replacement residence.

All of the gain may be deferred if you buy a new principal residence at a cost of at least $130,000, equal to the total insurance and land sale proceeds. The residence must be purchased before 2001. The replacement period ends December 31, 2000, four years after the close of the first year (1996) in which any gain was realized.

If the destroyed home had been a second home rather than your principal residence, the same gain deferral rules would apply except that the replacement period would end December 31,1998.

¶18.3 Who May Claim the Loss Deduction

The casualty and theft loss deduction may be claimed only by the owner of the property. For example, a husband filing a separate return may not deduct the loss of jewelry belonging to his wife; only she may deduct it on her separate return.

On jointly owned property, the loss is divided among the owners. If you and your spouse own the property jointly, you deduct the entire loss on a joint return. If you file separately, each owner deducts his or her share of the loss on each separate return.

If you have a legal life estate in the property, the loss is apportioned between yourself and those who will get the property after your death. The apportionment may be based on actuarial tables that consider your life expectancy.

You may claim a casualty loss for property lost or destroyed by your dependent if you own the property. You may not claim a loss deduction for destroyed property that belongs to your child who has reached majority, even though he or she is still your dependent.

Lessee. A person leasing property may be allowed to deduct payments to a lessor that compensate for a casualty loss. A tenant was allowed to deduct as a casualty loss payment of a judgment obtained by the landlord for fire damage to the rented premises which had to be returned in the same condition as at the start of the lease. However, the Tax Court does not allow a deduction for the cost of repairing a rented car, as the lessee has no basis in the car.

Damage to nearby property. The casualty must have caused damage to your property. Damage to a nearby area which lowered the value of your property does not give you a loss deduction.

EXAMPLE

You buy or lease a lot on which to build a cottage. Along with your purchase or lease, you have the privilege of using a nearby lake. The lake is later destroyed by a storm and the value of your property drops. You may not deduct the loss. The lake is not your property. You had only a privilege to use it, and this is not an ownership right which supports a casualty loss deduction.

¶18.4 Bank Deposit Losses

If a bank in which you deposit funds fails and your loss is not covered by insurance, generally you may claim your loss either as a bad debt deduction or casualty loss. Furthermore, if none of the deposits were federally insured, an investment loss may be claimed.

Bad debt. You may claim a bad debt deduction for a loss of a bank deposit in the year there is no reasonable prospect of recovery from the insolvent or bankrupt bank. You claim the loss as a short-term capital loss on Schedule D unless the deposit was made in your business. A nonbusiness bad debt deduction is deductible from capital gains. If you do not have capital gains or the bad debt loss exceeds capital gains, only $3,000 of the loss may offset other income. The remaining loss is carried over. A lost deposit of business funds is claimed as a business bad debt; *see* ¶5.9.

Casualty loss. You may elect to take a casualty loss deduction for the year in which the loss can be reasonably estimated. The loss is subject to the 10% AGI floor for casualty losses. Once the casualty loss election is made, it is irrevocable and will apply to all other losses on deposits in the same financial institution.

The casualty loss election may allow you to claim the loss in an earlier year because you do not have to wait until the year there is no prospect of recovery as required in the case of bad debts. The casualty loss election may also be advisable if other casualty losses may absorb all or part of the 10% AGI floor. The casualty loss election is not allowed to stockholders of the bank with more than a 1% interest, officers of the bank, or their relatives.

Investment loss. If *none* of your deposits were federally insured and you reasonably estimate that you will not recover the funds, up to $20,000 ($10,000 if married filing separately) may be claimed on Schedule A as an investment loss subject to the 2% adjusted gross income floor for miscellaneous itemized deductions. The $20,000 limit (or $10,000) applies to total losses from any one financial institution, regardless of how many accounts you have. A separate $20,000 deduction limit applies to each financial institution. The $20,000 (or $10,000) limit is reduced by any insurance proceeds authorized by *state* law that you reasonably expect to receive. If your other miscellaneous deductions exceed 2% of adjusted gross income, claiming investment loss treatment may be preferable to treating the loss as a casualty subject to the 10% floor or a bad debt subject to the $3,000 limit. If you claimed a bad debt deduction for a lost deposit in a prior year and you qualify for the investment loss, you may file an amended return to claim the investment loss if the statute of limitations has not passed.

Reasonable estimate of casualty or investment loss. Generally, the trustees of the troubled bank will provide depositors with an estimate of the expected recovery and loss. In the year of that determination, you may claim the estimated loss deduction. If you deduct an estimated loss that is less than you are entitled to, you may claim the additional loss in the year of the final determination as a bad debt. If you deduct more than the actual loss, the excess loss must be reported as income in the year of the final determination. Failure to claim the loss in the year in which the loss can first be reasonably estimated does not bar a deduction in a later year.

For any particular year, only one election may be made for losses in the same bank. If you elect the up-to-$20,000 investment loss for losses in one bank and your loss exceeds the limit, the balance may not be claimed as a casualty deduction. Similarly, if you elect casualty loss treatment, the amount that is not deductible because of the $100 and 10% of the adjusted gross income floors is not deductible under the $20,000 investment loss rule.

¶18.5 Sudden Event Test for Personal Property Losses

A loss of personal-use property must result from a sudden and destructive force. Chance or a natural phenomenon must be present. Examples include earthquakes, hurricanes, tornadoes, floods, severe storms, landslides, and fires. Loss due to vandalism during riots or civil disorders also is treated as a casualty loss. Damage to your car from an accident is generally deductible; *see* ¶18.7. Courts have allowed deductions for other types of accidents; *see* Example 2 in the next column. The requirement of suddenness is designed to bar deductions for damage caused by a natural action such as erosion, corrosion, and termite infestation occurring over a period of time.

Foreseeable events and preventable accidents. The IRS may try to disallow a deduction by claiming that the loss was foreseeable and therefore not a deductible casualty loss; *see* the Example at the end of this section.

EXAMPLES

1. A homeowner claimed a loss for water damage to wallpaper and plaster. The water entered through the window frame. The loss was disallowed. He gave no evidence that the damage came from a sudden or destructive force, such as a storm. The damage may have been caused by progressive deterioration.
2. Mr. White accidentally slammed the car door on his wife's hand. In pain, she shook her hand vigorously. A diamond flew out of her ring's setting, which was loosened by the impact. It was never found. The IRS disallowed the deduction, contending that a casualty loss requires a cataclysmic event. The Tax Court disagreed. A deductible casualty loss occurs whenever an accidental force is exerted against property, and its owner is powerless to prevent the damage because of the suddenness. The IRS has accepted the decision.
3. A boat, which was in a poor state of repair, was equipped with a pump that automatically began operating when the water in the hull rose above a certain level. One day, the dockside power source failed, and the boat sank at its mooring within four hours. The IRS claimed that no deductible type of casualty occurred because the leakage was a chronic problem. The Tax Court allowed the deduction. The sinking was not a direct result of the boat's leaking hull, but of the failure of the on-board water pump.
4. Floods damaged 12 homes which were razed by local authorities for safety reasons. Although Finkbohner's home suffered only minor damage, he claimed that the removal of the neighboring homes decreased the attractiveness of the neighborhood and made it more susceptible to crime. He estimated that the value of his home fell from $120,000 to $95,000 and claimed a casualty loss for the $25,000 difference.

   The IRS disallowed the loss on the grounds that it was not based on actual physical damage. It allowed a deduction only for the cost of repairs, about $1,200. A federal district court jury allowed a $12,500 casualty loss after being instructed by the trial judge that permanent buyer resistance after the flood damage to the neighborhood is basis for a loss deduction.

   An appeals court upheld the loss because permanent buyer resistance affected the value of the home. The court distinguished Finkbohner's case from that of a homeowner who, after a flood and mudslide, was barred from deducting a loss based on fears of future floods. In that situation, the owner was trying to claim a loss that could only be deducted, if and when a future disaster occurred, by the future owner. Here, the buyer resistance confronting Finkbohner was not based on expected future casualties, but on changes to their neighborhood that already occurred.

Is drought damage deductible? The IRS does not generally allow deductions for drought damage. An agent may argue that the loss resulted from progressive deterioration which does not fit the legal definition of a personal casualty loss. Courts have allowed deductions for severe drought where the damages occur in the same year as the drought.

If the damage becomes noticeable a year later, a court will view this as evidence of progressive deterioration which does not qualify as a deductible casualty. Where there are drought conditions, inspect your property for damage before the end of the year and claim a deduction for the damage in that year to negate an IRS argument that damage was caused by progressive deterioration.

Damage to surrounding property. Loss due to buyer resistance because of damage to surrounding property is generally not deductible. However, a deduction was allowed by a federal district court and an appeals court.

Termites. Termite damage is generally nondeductible since it often results from long periods of termite infestation. Proving a sudden action in the sense of fixing the approximate moment of the termite invasion is difficult. Some courts have allowed a deduction, but the IRS will bar deductions for termite damage under any conditions based on a study that found that serious termite damage results only after an infestation of three to eight years. Examples of other nondeductible casualty losses are at ¶18.9.

Damage to trees. The destruction of trees by southern pine beetles over a period of 5–10 days was held by the IRS to be a casualty. One court decided similarly where the destruction occurred over a 30-day period. For figuring the casualty deduction for tree and shrub damage, *see* ¶18.6.

Deduction despite faulty construction. A plumber stepped on a pipe which was improperly installed. Resulting underground flooding caused damage of over $20,000. The IRS argued that this was caused by a construction fault and is not a casualty loss. The Tax Court disagreed. The plumber caused the damage. Improper construction was only an element in the causative chain.

Preventive measures not deductible. The cost of preventive measures, such as burglar alarms or smoke detectors, or the cost of boarding up property against a storm, is not deductible.

EXAMPLES

1. Heyn owned a hillside lot on which he contracted for the building of a home. A soil test showed a high proportion of fine-grain dense sandstone, which is unstable. His construction contract called for appropriate shoring up and support. But, because of the contractor's negligence, a landslide occurred. The IRS disallowed the loss on the ground that it was not a "casualty" because the danger was known before Heyn undertook the project and because of the negligence involved. The court disagreed. The contractor's negligence is not a factor in determining whether there was a casualty. For example, an automobile collision is considered a casualty, even if caused by negligent driving. Foreseeability is not a factor. A weather report may warn property owners to take protective steps against an approaching hurricane, but losses caused by the hurricane are deductible. The IRS has agreed to accept the decision.
2. Mrs. Kane placed her dirty ring in a glass of ammonia. Not knowing the contents of the glass, her husband emptied it into the sink and started the automatic garbage disposal, crushing the ring. The court allowed a full deduction for the loss which it said resulted from a destructive force. That Mr. Kane was negligent has no bearing on whether the event was a casualty.
3. At Christmas time in 1982, Hananel left his 1974 Plymouth Valiant in Chicago in an area in which the city was towing away cars to make room for construction work. When he returned a week later, he found that his car was missing and reported it stolen. A month later, he learned that the city pound had towed the car away and then crushed it because its ownership could not be determined. He claimed a casualty loss for the car. The IRS disallowed the deduction, claiming that the towing and crushing was not an unforeseeable event, and thus did not qualify as a casualty.

   The Tax Court agreed that Hananel could have foreseen that leaving the car on the street subjected it to being towed. He was negligent. However, the penalty for this is a towing charge. He could not have foreseen its destruction. Therefore, the destruction occurred from an unusual and unexpected event, and he was allowed to claim a casualty loss deduction.
4. Destruction of a lawn through the careless use of weed killer has been held to be a casualty.

¶18.6 Damage to Trees and Shrubs

Not all damage to trees and shrubs qualifies as a casualty loss. The damage must be occasioned by a sudden event; *see* ¶18.5. Destruction of trees over a period of 5–10 days by southern pine beetles is deductible. One court allowed a deduction for similar destruction over a 30-day period. However, damage by Dutch Elm disease or lethal yellowing disease has been held to be gradual destruction not qualifying as a casualty loss. The Tax Court has allowed a deduction for the cost of removing infested trees.

If shrubbery and trees on *personal-use property* are damaged by a sudden casualty, you figure the loss on the value of the entire property before and after the casualty. You treat the buildings, land, and shrubs as one complete unit; *see* Example 2 on the next page.

In fixing the loss on *business or income-producing property*, however, shrubs and trees are valued separately from the building; *see* Example 1 on the next page.

EXAMPLES

1. Wayne Smith bought an office building for $90,000. The purchase price was allocated between the land ($18,000) and the building ($72,000). Smith planted trees and ornamental shrubs on the grounds surrounding the building at a cost of $1,200. When the basis of the building had been depreciated to $66,000, a hurricane caused extensive property damage. The fair market value of the land and building immediately before the hurricane was $18,000 and $80,000; immediately afterwards it was $18,000 and $52,000. The fair market value of the trees and shrubs immediately before the casualty was $2,000 and immediately afterwards, $400. Insurance of $15,000 is received to cover damage to the building. Deductible losses are figured separately for the building and the trees and shrubs. The deduction for the building is $13,000, computed as follows:

Value of building immediately before casualty	$80,000
Less: Value immediately after casualty	52,000
Loss in value	$28,000
Less: Insurance received	15,000
Deduction allowed	$13,000

The deduction for the trees and shrubs is $1,200:

Value immediately before casualty	$ 2,000
Less: Value of trees immediately after casualty	400
Loss in value	$1,600*

*However, the deductible loss cannot exceed the adjusted basis of the property, $1,200.

2. Same facts as in Example 1, except that Smith purchases a personal residence instead of an office building. Smith's adjusted gross income is $25,000, and this is his only loss. No allocation of the purchase price is necessary for the land and house because the property is not depreciable. Likewise, no individual evaluation of the fair market values of the land, house, trees, and shrubs is necessary. The amount of the deduction for the land, house, trees, and shrubs is $12,000, computed as follows:

Value of property immediately before casualty		$100,000
Less: Value of property immediately after casualty		70,400
Loss in value		$29,600
Less: Insurance received	$15,000	
10% and $100 floors	2,600	17,600
Deduction allowed		$12,000

¶18.7 Deducting Damage to Your Car

Damage to your car in an accident may be a deductible casualty loss unless caused by your willful conduct, such as drunken driving.

You may not deduct legal fees and costs of a court action for damages or money paid for damages to another's property because of your negligence while driving for commuting or other personal purposes. But if at the time of the accident you were using your car on business, you may deduct as a business loss a payment of damages to the other party's car. For purposes of a business loss deduction, driving between two locations of the same business is considered business driving but driving between locations of two separate businesses is considered personal driving. Therefore, the payment of damages arising from an accident while driving between two separate businesses is not deductible.

A court has allowed deductions for damage resulting from a child pressing the starter button of a car and from flying stones while driving over a temporary road. In a private letter ruling, the IRS disallowed a loss for damage to a race car by an amateur racer on the ground that in races, crashes are not an unusual event and so do not constitute a casualty.

If the deduction is questioned, be prepared to show the amount, if any, of your insurance recovery. A deduction is allowed only for uninsured losses. Not only must the loss be proved, but also that it was not compensated by insurance.

Towing costs are not included as part of the casualty loss.

A parent may not claim a casualty loss deduction for damage to a car registered in a child's name, although the parent provided funds for the purchase of the car.

Expenses of personal injuries arising from a car accident are not a deductible casualty loss.

Automobile used partly for business. When you use an automobile partly for personal use and partly for business, your loss is computed as though two separate pieces of property were damaged—one business and the other personal. The $100 and 10% floors reduce only the loss on the part used for personal purposes.

¶18.8 Theft Losses

The taking of property must be illegal under state law to support a theft loss deduction. That property is missing is not sufficient evidence to sustain a theft deduction. It may have been lost or misplaced. So if all you can prove is that an article is missing or lost, your deduction may be disallowed. Sometimes, of course, the facts surrounding the disappearance of an article indicate that it is reasonable to assume that a theft took place. A deduction has been allowed for the theft of trees.

You deduct a theft loss in the year you discover the property was stolen. If you have a reasonable chance of being reimbursed for your loss, you may not take a deduction until the year in which you learn there is no reasonable prospect of recovery.

A legal fee paid to recover stolen property has been held to be deductible as part of the theft loss.

To figure the amount of a theft loss deduction, *see* ¶18.12.

Proving a Theft

Get statements from witnesses who saw the theft or police records documenting a break-in to your house or car. A newspaper account of the crime might also help.

When you suspect a theft, make a report to the police. Even though your reporting does not prove that a theft was committed, it may be inferred from your failure to report that you were not sure that your property was stolen. But a theft loss was allowed where the loss of a ring was not reported to the police or an attempt made to demand its return from the suspect, a domestic employee. The owner feared being charged with false arrest.

Fraud by building contractors. A deduction was allowed when a building contractor ran away with a payment he received to build a residence. The would-be homeowner was allowed a theft loss deduction for the difference between the money he advanced to the contractor and the value of the partially completed house. In another case, a theft deduction was allowed for payments to subcontractors. The main contractor had fraudulently claimed that he had paid them before he went bankrupt.

Embezzlement losses are deductible as theft losses in the year the theft is discovered. However, if you report on a cash basis, you may not take a deduction for the embezzlement of income you have not reported. For example, an agent embezzled royalties of $46,000 due an author. The author's theft deduction was disallowed. The author had not previously reported the royalties as income; therefore, she could not get the deduction.

Fraudulent sales offers. Worthless stock purchases made on the representation of false and fraudulent sales offers are deductible as theft losses in the year there is no reasonable prospect of recovery. However, the illegal sale of unregistered stock does not support a theft loss deduction.

Kidnapping ransom. Payment of ransom to a kidnapper is generally a deductible theft loss. However, the expense of trying to find an abducted child is not a theft loss.

Fortune tellers. The Tax Court allowed a theft loss deduction in New York, where fortune telling is by law a theft-related offense. The law assumes that telling fortunes or promising to control occult forces is a form of fraud. An exception is made for fortune telling at shows for the purpose of entertaining or amusement. That a person voluntarily asks for advice does not bar the deduction. According to the court, a gullible person who gives money to fortune tellers in the belief that he or she will be helped is still defrauded or swindled. Theft is a broad term and includes theft by swindling, false pretenses, and any other form of guile. In this case, the taxpayer, who was suffering from mental depression, had become attached to two fortune tellers whom he claimed took him for over $19,000.

Riot losses. Losses caused by fire, theft, and vandalism occurring during riots and civil disorders are deductible. When a reception is canceled because of a curfew, no loss deduction is allowed for perishable food that is discarded.

To support your claim of a riot loss, keep evidence of the damage suffered and the cost of repairs. Photographs taken prior to repairs or replacement, lists of damaged or missing property, and police reports would help to establish and uphold your loss deduction.

Foreign government confiscations. The IRS and courts have disallowed deductions for confiscations of personal property by foreign governments.

Swindled by friend. A theft loss deduction was allowed to a widow who gave her old beau over $2 million to acquire stock for her in his bank. He used the money to pay his personal debts. The IRS barred the theft loss, arguing that the widow failed to prove fraud. A district court disagreed and allowed the deduction. Under Oklahoma state law, a person who makes a promise in return for cash has committed larceny by fraud if he never intended to return the funds or make good on the promise. Here, that the widow gave him the money voluntarily does not bar a theft loss deduction. She parted with the funds based upon his false claim that he would invest the money for her when he had no intention of doing so, but planned all along to pay off his debts with the funds.

If Stolen Property Is Recovered

If you claim a theft loss and in a later year the property is returned to you, you must refigure your loss deduction. If the refigured deduction is lower than the amount you claimed, the difference must be reported as income in the year of the recovery. To recalculate the loss, follow the steps in ¶18.12 for figuring deductible losses, but in Step 1, compute the loss in fair market value from the time the property was stolen until you recovered it. The lower of this loss in value, if any, and your adjusted basis for the property is then reduced by insurance reimbursements and the personal floors (¶18.11) to get the recalculated loss.

¶18.9 Nondeductible Losses

Certain losses, though "casualties" for you, may not be deducted if they are not due to theft, fire, or from some other sudden natural phenomenon. The following losses are not deductible:

- Termite damage; *see* ¶18.5.
- Carpet beetle damage.
- Dry rot damage.
- Damages for personal injuries or property damage to others caused by your negligence.
- Legal expenses in defending a suit for your negligent operation of your personal automobile.
- Legal expenses to recover personal property wrongfully seized by the police.
- Expenses of moving to and rental of temporary quarters.
- Loss of personal property while in storage or in transit.
- Loss of passenger's luggage put aboard a ship. The passenger missed the boat and the luggage could not be traced.
- Accidental loss of a ring from your finger.
- Injuries resulting from tripping over a wire.
- Loss by husband of joint property taken by his wife when she left him.
- Loss of a valuable dog which strayed and was not found.
- Damage to a crop caused by plant diseases, insects, or fungi.
- Damage to property from drought in an area where a dry spell is normal and usual.
- Damage to property caused by excavations on adjoining property.
- Damage from rust or corroding of understructure of house.
- Moth damage.
- Dry well.
- Losses occasioned by water pockets, erosion, inundation at still water levels, and other natural phenomena. (There was no sudden destruction.)
- Amount paid to a public library for damages to a book you borrowed.
- Death of a saddle horse after eating a silk hat.
- A watch or spectacles dropped on the ground.
- Sudden drop in the value of securities.
- Loss in earnings of a lawyer resulting from his illness.
- Loss of contingent interest in property due to the unexpected death of a child.
- Improper police seizure of private liquor stock.
- Chinaware broken by a family pet.
- Temporary fluctuation in value.
- Loss of tree from Dutch Elm disease and lethal yellowing disease.
- Loss of trees after horse ate bark.
- Damage to property from local government construction project.
- Fire purposely set by owner.

Note: Some of the above items may be allowed as business expenses.

Key to Proving a Casualty Loss

To prove—	*You need this information—*
That a casualty actually occurred	With a well-known casualty, like regional floods, you will have no difficulty proving the casualty occurred, but you must prove it affected your property. Photographs of the area, before and after, and newspaper stories placing the damage in your neighborhood are helpful. If only your property is damaged, there may be a newspaper item on it. Some papers list all the fire alarms answered the previous day. Police, fire, and other municipal departments may have reports on the casualty.
The cost of repairing the property	Cost of repairs is allowed as a measure of loss of repairing the value if it is not excessive and the repair merely restored your property to its condition immediately before the casualty. Save cancelled checks, bills, receipts, and vouchers for expenses of clearing debris and restoring the property to its condition before the casualty.
The value immediately before and after the casualty	Appraisals by a competent expert are important. Get them in writing—in the form of an affidavit, deposition, estimate, appraisal, etc. The expert—an appraiser, engineer, or architect—should be qualified to judge local values. Any records of offers to buy your property, either before or after the casualty, are helpful. Automobile "blue books" may be used as guides in fixing the value of a car. But an amount offered for your car as a trade-in on a new car is not usually an acceptable measure of value.
Cost of your property—the deductible loss cannot be more than that	A deed, contract, bill of sale, or other document probably shows your original cost. Bills, receipts, and canceled checks show the cost loss cannot be more than that of improvements. One court refused to allow a deduction because an owner failed to prove the original cost of a destroyed house and its value before the fire. In another case, estimates were allowed where a fire destroyed records of cost. A court held that the homeowner could not be expected to prove cost by documents lost in the fire that destroyed her property. She made inventories after the fire and again at a later date. Her reliance on memory to establish cost, even though inflated, was no bar to the deduction. The court estimated the market value based on her inventories. If you acquired the property by gift or inheritance, you must establish an adjusted basis in the property from records of the donor or the executor of the estate; *see* ¶5.21 and ¶5.22.

Form 4684 — Worksheet (see Example 1, page 290)

SECTION A—Personal Use Property (Use this section to report casualties and thefts of property **not** used in a trade or business or for income-producing purposes.)

1 Description of properties (show type, location, and date acquired for each):

Property A Residence 2-3-86

Property B Furniture 3-15-87

Property C

Property D

		Properties (Use a separate column for each property lost or damaged from one casualty or theft.) A	B	C	D
2 Cost or other basis of each property	2	76,000	5,000		
3 Insurance or other reimbursement (whether or not you filed a claim). See instructions **Note:** *If line 2 is **more than** line 3, skip line 4.*	3	2,000	500		
4 Gain from casualty or theft. If line 3 is **more than** line 2, enter the difference here and skip lines 5 through 9 for that column. See instructions if line 3 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	4				
5 Fair market value **before** casualty or theft	5	167,500	2,000		
6 Fair market value **after** casualty or theft	6	162,500	0		
7 Subtract line 6 from line 5	7	5,000	2,000		
8 Enter the **smaller** of line 2 or line 7	8	5,000	2,000		
9 Subtract line 3 from line 8. If zero or less, enter -0-	9	3,000	1,500		

10 Casualty or theft loss. Add the amounts on line 9. Enter the total	10	4,500
11 Enter the amount from line 10 or $100, whichever is **smaller**	11	100
12 Subtract line 11 from line 10 **Caution:** *Use only one Form 4684 for lines 13 through 18.*	12	4,400
13 Add the amounts on line 12 of all Forms 4684	13	4,400
14 Combine the amounts from line 4 of all Forms 4684	14	-0-
15 • If line 14 is **more than** line 13, enter the difference here and on Schedule D. Do not complete the rest of this section (see instructions). • If line 14 is **less than** line 13, enter -0- here and continue with the form. • If line 14 is **equal to** line 13, enter -0- here. Do not complete the rest of this section.	15	-0-
16 If line 14 is **less than** line 13, enter the difference	16	4,400
17 Enter 10% of your adjusted gross income (Form 1040, line 32). Estates and trusts, see instructions	17	2,800
18 Subtract line 17 from line 16. If zero or less, enter -0-. Also enter result on Schedule A (Form 1040), line 19. Estates and trusts, enter on the "Other deductions" line of your tax return	18	1,600

¶18.10 Proving a Casualty Loss

If your return is audited, you will have to prove that the casualty occurred and the amount of the loss. The time to collect your evidence is as soon after the casualty as possible. The Key to Proving a Casualty Loss, on page 289, indicates the information that you will need when computing your loss under the steps explained in ¶18.12.

¶18.11 Floors for Personal-Use Property Losses

Casualty and theft losses to personal-use property are subject to "floors" that will reduce, and in some cases eliminate, your deduction. For each casualty or theft, a $100 reduction applies after the loss is computed under the steps of ¶18.12. In addition, personal casualty and theft losses (after the $100 reduction) are deductible only to the extent they exceed 10% of your adjusted gross income.

The $100 floor. The $100 floor reduces casualty and theft losses of property used for personal purposes; *see* step 4 of ¶18.12. The $100 floor does not apply to losses of business property or property held for the production of income such as securities. If property used both in business and personal activities is damaged, the $100 offset applies only to the loss allocated to personal use.

For each casualty or theft during the year, a separate $100 reduction applies. For example, you are involved in five different casualties during the year. There will be a $100 offset applied to each of the five losses. But when two or more items of property are destroyed in one event, only one $100 offset is applied to the total loss. For example, a storm damages your residence and also your car parked in the driveway. You figure the loss on the residence and car separately, but only one $100 offset applies to the total loss.

The $100 floor is applied after taking into account insurance proceeds received and insurance you expect to receive in a later year. For example, in 1996, you incur a casualty loss of $290, on which you expect a reimbursement of $250. Thus, your unreimbursed loss in 1996 is $40, but you may not deduct the amount as it does not exceed $100. Now assume that in 1997 you learn that you cannot recover the expected reimbursement of $250. In figuring a casualty loss deduction in 1997, you reduce the $250 by $60; $40 of the $100 limitation had applied to part of the same casualty loss in 1996.

The $100 floor applies separately to the loss of each individual whose property has been damaged by a single casualty, even where the damaged property is owned by two or more individuals. The only exception is for a married couple filing jointly who apply only one $100 floor to their losses from a single casualty.

EXAMPLES

1. Two sisters own and occupy a house which is damaged in a storm. Each sister applies the $100 floor to figure her separate deduction.
2. Your house is partially damaged by a fire which also damages the personal property of a houseguest. You are subject to one $100 floor and the houseguest is subject to a separate $100 floor.

Spouses. Where a husband and wife file a joint return, only one $100 floor applies, whether the property is owned jointly or separately. If separate returns are filed, each spouse must reduce his or her half of the loss on jointly owned property by $100. If the property is owned by one spouse, only that spouse can claim a casualty loss on a separate return.

10% AGI floor. The 10% adjusted gross income (AGI) floor applies to the total of all losses occurring during the taxable year to personal-use property. The Example below illustrates the application of the $100 floor to each separate casualty event and the 10% AGI floor to the total losses.

EXAMPLE

In January 1996, you have an uninsured jewelry theft loss of $1,000, and in July 1996 uninsured damage of $3,000 to your personal car. Your adjusted gross income is $25,000. Your deduction is $1,300 figured as follows:

Theft loss	$1,000	
Less	100	$ 900
Car damage	3,000	
Less	100	2,900
Total loss		3,800
Less 10% of $25,000		2,500
Deductible loss		$1,300

¶18.12 Figuring Your Loss on Form 4684

The deductible loss is usually the difference between the fair market value of the property before and after the casualty or theft *less* (1) reimbursements received for the loss; and (2) $100 if the property was used for personal purposes. However, the loss may not exceed your adjusted basis (¶5.24) for the property, which for many items will be your cost. If your adjusted basis is less than the loss in value,

your deduction is limited to basis, less reimbursements and the $100 floor for personal-use assets. After figuring all allowable casualty and theft losses for personal-use property, the total is deductible only to the extent it exceeds the 10% adjusted gross income floor (¶18.11). Use the following five-step method for figuring the deductible amount.

Steps for calculating your deductible loss. The following five steps reflect the procedure on Form 4684 for computing a casualty or theft loss. Form 4684 is used to report casualties or thefts of personal-use property, business property, or income-producing property. However, if your loss is to business inventory, you do not have to use Form 4684, but may take the loss into account when figuring the cost of goods sold; *see* Inventory losses later in this section.

To figure your deductible loss, follow these five steps:

Step 1. Compute the loss in fair market value of the property. This is the difference between the fair market value immediately before and immediately after the casualty. You will need written appraisals to support your claim for loss of value. You may not claim sentimental or aesthetic values or a fluctuation in property values caused by a casualty; you must deal with cost or market values of what has been lost. If the value of your property has been lowered because of damage to a nearby area, you do not have a deductible loss since your own property has not been damaged. No deduction may be claimed for estimated decline in value based on buyer resistance in an area subject to landslides.

For household items, the Tax Court has allowed losses to be based on cost *less* depreciation, rather than on the decrease in fair market value; *see* the Example in the left column of page 293.

Step 2. Compute your adjusted basis for the property. This is usually the cost of the property plus the cost of improvements, less previous casualty loss deductions and depreciation if the property is used in business or for income-producing purposes. Unadjusted basis of property acquired other than by purchase is explained at ¶5.20. Adjusted basis is explained at ¶5.24.

Step 3. Take the lower of Step 1 and 2. The lower amount, reduced by the adjustments in Step 4, is your casualty loss, with one exception: Where property used for business or income-producing purposes is totally destroyed, and before the casualty its market value is less than its adjusted basis, the measure of the loss is the adjusted basis, *less* any salvage value.

Indirect expenses, such as for personal injury, temporary lights, fuel, moving, or rentals for temporary living quarters, are not deductible as casualty losses.

Step 4. Reduce the loss in Step 3 by the insurance proceeds or other compensation for the loss; *see* ¶18.15. If the property was used for personal purposes, also reduce the loss by $100; *see* ¶18.11.

Step 5. If the property was used for personal purposes, the loss is allowed only if it exceeds 10% of your adjusted gross income. If you have more than one personal casualty or theft, reduce the total combined loss by 10% of adjusted gross income; only the excess is deductible; *see* ¶18.11.

EXAMPLES

1. Your home, which cost $76,000 in 1986, was damaged by a fire. The value of the house before the disaster was $167,500, but afterwards $162,500. The furniture cost $5,000 in 1987. Its value before the fire was set at $2,000. It was totally destroyed. The insurance company reimbursed you $2,000 for your house damage and $500 for your furnishings. This was the only casualty for the year. Your adjusted gross income is $28,000. You figure your loss for the furniture separately from the loss on the house but apply only one $100 reduction (¶18.11) because the damage was from a single casualty.

1. Decrease in home's fair market value:	
Value of house before fire	$167,500
Value of house after fire	162,500
Decrease in value	$ 5,000
2. Adjusted basis:	$ 76,000
3. Loss sustained (lower of 1 and 2)	$5,000
Less: Insurance	2,000
Loss on house	$3,000
4. Loss on furnishings (decreased value)*	$2,000
Less: Insurance	500
Loss on furnishings	$1,500
5. Total loss ($3,000 and $1,500)	$4,500
Less: $100 floor	100
Casualty loss (subject to 10% floor)	$4,400

After applying the 10% adjusted gross income floor, you may deduct $1,600 on Schedule A ($4,400 – $2,800 or 10% of $28,000).

See the sample Form 4684 on page 290 for how this loss is reported.

*The loss for the furnishings on Line 4 is $2,000, the decrease in fair market value, as this is lower than the $5,000 basis.

2. Depreciable business property with a fair market value of $1,500 and an adjusted basis of $2,000 is totally destroyed. Because property used in your business was totally destroyed (*see* Step 3 above), your loss is measured by your adjusted basis of $2,000, which is larger than the $1,500 loss in fair market value. Salvage value, if any, reduces your deduction, but you disregard the $100 floor applied to casualty losses on personal property. If the property was used for personal purposes, the loss would have been limited to the $1,500 loss in market value less $100, leaving a loss of $1,400 subject to the 10% adjusted gross income floor.

Reporting on Form 4684

If you are claiming a loss for personal-use property, use Section A on page one of Form 4684. If you suffered more than one casualty or theft during the year, use a separate Form 4684 for each one. The total deductible casualty or theft loss from Section A of Form 4684 is then entered on Schedule A of Form 1040.

If you are claiming a loss for property used in your business or income-producing activity, use Section B on page 2 of Form 4684. Losses from income-producing property are generally entered on Schedule A as a miscellaneous itemized deduction subject to the 2% adjusted gross income floor. Losses from business property are generally netted against gains and the result entered on Form 4797; follow the instructions to Form 4684.

Inventory losses. A casualty or theft loss of inventory is automatically reflected on Schedule C in the cost of goods sold, which includes the lost items as part of your opening inventory. Any insurance or other reimbursement received for the loss must be included as sales income.

You may separately claim the inventory loss as a casualty or theft loss on Form 4684 instead of automatically claiming it as part of the cost of goods sold. If you do this, you must eliminate the items from inventory by lowering either opening inventory or purchases when figuring the cost of goods sold.

Cost less depreciation method for household items. The Tax Court has allowed casualty loss deductions based on cost less depreciation, rather than on the difference in fair market value immediately before and after the casualty.

EXAMPLE

Basing a deduction on the loss in value due to the casualty generally limits your deduction to the going price for secondhand furnishings. A homeowner whose furniture was destroyed by fire claimed that the fair market value immediately before the fire should be original cost less depreciation. He based his figures on an inventory prepared by certified public adjusters describing each item, its cost and age. The deduction figured this way came to approximately $27,500 ($55,000 cost, less $13,000 depreciation, a $14,400 insurance recovery, and the $100 floor).

The IRS estimated that the furniture was worth $15,304 before the fire and limited the deduction to $804 after setting off the insurance and the $100 floor. The Tax Court disagreed. The householder's method of valuing his furniture is consistent with methods used by insurance adjusters who have an interest in keeping values low. He is not limited to the amount his property would bring if "hawked off by a secondhand dealer or at a forced sale." However, in another case, the court refused to allow the cost less depreciation formula where the homeowner's inventory list was based on memory.

Keep Records of Deductible Losses

If your property is damaged, you must reduce the basis of the damaged property by the casualty loss deduction and compensation received for the loss; *see* ¶5.24. When you later sell the property, gain or loss is the difference between the selling price and the reduced basis.

¶18.13 Personal and Business Use of Property

For property held partly for personal use and partly for business or income-producing purposes, a casualty or theft loss deduction is computed as if two separate pieces of property were damaged, destroyed, or stolen. Follow the steps of ¶18.12 for figuring the allowable loss, but apply the $100 and 10% of adjusted gross income floors only to the personal part of the loss.

EXAMPLE

A building with two apartments, one used by the owner as his home and the other rented to a tenant, is damaged by a fire. The fair market value of the building before the fire was $169,000 and after the fire, $136,000. Its cost basis was $120,000. Depreciation taken before the fire was $14,000. The insurance company paid $20,000. The owner has adjusted gross income of $40,000. This is his only loss this year. He has a business casualty loss of $6,500 and a deductible personal casualty loss of $2,400 figured as follows:

		Business	*Personal*
1.	Decrease in value of building:		
	Value before fire ($169,000)	$84,500	$84,500
	Value after fire ($136,000)	(68,000)	(68,000)
	Decrease in value	$16,500	$16,500
2.	Adjusted basis of building:	$60,000	$60,000
	Less: Depreciation	(14,000)	
	Adjusted basis	$46,000	$60,000
3.	Loss sustained (lower of 1 and 2)	$16,500	$16,500
	Less: Insurance (total $20,000)	($10,000)	($10,000)
4.	Loss	$6,500	$6,500
	Less: $100 floor and 10% of adjusted gross income	—	(4,100)
	Deductible casualty loss	$6,500	$2,400

¶18.14 Repairs May Be a "Measure of Loss"

The cost of repairs may be treated as evidence of the loss of value (Step 1 of ¶18.12), if the amount is not excessive and the repairs do nothing more than restore the property to its condition before the casualty. An estimate for repairs will not suffice; only actual repairs may be used as a measure of loss. However, where you measure your loss by comparing appraisals of value for before and after the casualty, repairs may be considered in arriving at a post-casualty value even though no actual repairs are made.

Deduction not limited to repairs. A casualty loss deduction is not limited to repair expenses where the decline in market value is greater, according to a federal appeals court; *see* the next Example.

EXAMPLE

Connor claimed that the market value of his house dropped $93,000 after it was damaged by fire. His $52,000 cash outlay in repairing the house was reimbursed by insurance. He claimed a casualty loss of approximately $40,000, the uncompensated drop in market value. The IRS barred the deduction. The house was restored to pre-casualty condition. The cost of the repairs is a realistic measure of the loss, and, as the expense was fully compensated by insurance, Connor suffered no loss. A federal appeals court disagreed. The house dropped $70,000 in market value, of which $20,000 was uncompensated by insurance. The deduction is measured by the uncompensated difference in value before and after the casualty. It is not limited to the cost of repairs, even where the repair expense is less than the difference in fair market values. Had the repairs cost more than this difference, the IRS would not have allowed a larger deduction.

¶18.15 Insurance Reimbursements

You reduce the amount of your loss (¶18.12) by insurance proceeds, voluntary payments received from your employer for damage to your property, and cash or property received from the Red Cross. Also reduce your loss by reimbursements you expect to receive in a later year; *see* ¶18.1. However, cash gifts from friends and relatives to help defray the cost of repairs do not reduce the loss where there are no conditions on the use of the gift. Also, gifts of food, clothing, medical supplies, and other forms of subsistence do not reduce the loss deduction nor are they taxable income.

Cancellation of part of a disaster loan under the Disaster Relief Act is treated as a partial reimbursement of the loss and reduces the amount of the loss. Payments from an urban renewal agency to acquire your damaged property under the Federal Relocation Act of 1970 are considered reimbursements reducing the loss.

Insurance payments for the cost of added living expenses because of damage to a home do not reduce a casualty loss. The payments are treated separate and apart from payments for property damage. Payments for excess living costs are generally not taxable; *see* ¶18.16.

Failure To Make an Insurance Claim

If you are insured for your full loss and do not file a claim because you do not want to risk cancellation of liability coverage, you may not claim a deduction. If you do not file an insurance claim but your loss exceeds the coverage, the noncovered loss is deductible. For example, if you have a $500 deductible on your automobile insurance policy, a loss of up to $500 for car damage would be allowed, subject to the $100 and 10% of adjusted gross income floors.

Passive activity property loss reimbursements. A reimbursement of a casualty or theft loss deduction is not considered passive activity income if the original loss was not treated as a passive deduction; *see* ¶10.1. The reimbursement may be taxed under the rule of ¶12.8.

Realizing a gain from insurance. If you receive insurance proceeds in excess of your adjusted basis for the property, you generally realize a gain, which you may be able to defer by buying replacement property; *see* ¶18.18.

¶18.16 Excess Living Costs Paid by Insurance Are Not Taxable

Your insurance contract may reimburse you for excess living costs when a casualty or a threat of casualty forces you to vacate your house. The payment is tax free if these tests are met:

1. Your principal residence is damaged or destroyed by fire, storm, or other casualty or you are denied use of it by a governmental order because of the occurrence or threat of the casualty.
2. You are paid under an insurance contract for living expenses resulting from the loss of occupancy or use of the residence.

Whether you have a taxable or tax-free reimbursement is figured at the end of the period you were unable to use your residence. Thus, if the dislocation covers more than one taxable year, the taxable income, if any, will be reported in the taxable year in which the dislocation ended.

The tax-free amount includes only excess living costs paid by the insurance company. The excess is the difference between (1) the actual living expenses incurred during the time you could not use or occupy your house, and (2) the normal living expenses which you would have incurred for yourself and members of your household during the period. Living expenses during the period may include the cost of renting suitable housing and extraordinary expenses for

transportation, food, utilities, and miscellaneous services. The expenses must be incurred for items and services (such as laundry) needed to maintain you in the same standard of living that you enjoyed before the loss and must be covered by the policy.

Where a lump-sum settlement does not identify the amount covering living expenses, an allocation is required to determine the tax-free portion. In the case of uncontested claims, the tax-free portion is that part of the settlement which bears the same ratio to total recovery as increased living expense bears to total loss and expense. If your claim is contested, you must show the amount reasonably allocable to increased living expenses consistent with the terms of the insurance contract, but not in excess of coverage limitations specified in the contract.

The exclusion from income does not cover insurance reimbursements for loss of rental income or for loss of or damage to real or personal property; such reimbursements for property damage reduce your casualty loss; *see* ¶18.15.

If your home is used for both residential and business purposes, the exclusion does not apply to insurance proceeds and expenses attributable to the nonresidential portion of the house. There is no exclusion for insurance recovered for expenses resulting from governmental condemnation or order unrelated to a casualty or threat of casualty.

The insurance reimbursement may cover part of your normal living expenses as well as the excess expenses due to the casualty. The part covering normal expenses is income; it does not reduce your casualty loss.

EXAMPLES

1. On March 1, your home was damaged by fire. While it was being repaired, you and your spouse lived at a motel and ate meals at restaurants. Costs are $1,200 at the motel, $1,000 for meals, and $75 for laundry services. You make the required March payment of $790 on your home mortgage. Your customary $40 commuting expense is $20 less for the month because the motel is closer to your work. Your usual commuting expense is therefore treated as not being incurred to the extent of the $20 decrease. Furthermore, you do not incur your customary $700 food expense for meals at home, $75 for utilities, and $60 for laundry at home. Your insurance company pays you $1,700 for expenses. The tax-free exclusion for insurance payments is limited to $1,420, computed in the third column. You must report as income $280 ($1,700 – $1,420).

	Expenses from casualty	*Expenses not incurred*	*Increase (Decrease)*
Housing	$1,200		$1,200
Utilities		$75	(75)
Meals	1,000	700	300
Transportation		20	(20)
Laundry	75	60	15
Total	$2,275	$855	$1,420

2. Same facts as Example 1 except that you rented the residence for $400 per month and the risk of loss was to the landlord. You did not pay the March rent. The excludable amount is $1,020 ($1,420 less $400 normal rent not incurred). You would have to report as income the excess of the insurance received over the $1,020 exclusion.

¶18.17 Do Your Casualty Losses Exceed Your Income?

If your casualty or theft losses exceed your income, you pay no tax in 1996. You may also carry the excess loss back to 1993 and file a refund claim for that year. Any remaining loss may be carried back to 1994 and 1995 and carried forward to 1997 through 2011, or you may just carry your loss forward 15 years until it is used up. The excess casualty loss is carried back or forward as a net operating loss. *See* ¶40.17 for net operating loss rules.

Note: The $100 and 10% of adjusted gross income floors for personal casualty losses apply only in the year of loss; you do not again reduce your loss in the carry-back or carryover years.

Taxable Gain From Involuntary Conversions

¶18.18 Defer Gain by Replacing Property

If your property is destroyed, damaged, stolen, or taken by a government authority, this is considered to be an *involuntary conversion* for tax purposes. If upon an involuntary conversion you receive insurance or other compensation that exceeds the adjusted basis of the property, you realize a taxable gain; but *see* "Principal residence" below.

You may elect to postpone tax on the full gain provided you invest the proceeds in replacement property the cost of which is equal to or exceeds the net proceeds from the conversion. Reinvestment requirements are discussed at ¶18.21–¶18.23. The replacement period for personal-use property is two years; for business and investment property it is two or three years depending on the type of involuntary conversion; for a residence and its contents involuntarily converted due to a Presidentially declared disaster (*see* ¶18.2) it is four years; *see* ¶18.21 for replacement periods. Your basis in the replacement property is its replacement cost, minus any postponed gain.

Principal residence. If your principal residence is destroyed or condemned, you may apply the deferral rule for involuntary conversions or the home deferral rule of ¶29.5.

If your principal residence is damaged in a Presidentially declared disaster, *see* ¶18.2 for special rules that eliminate gain on

insurance for unscheduled property and make it easier to defer gain on insurance proceeds received for other property.

¶18.19 Involuntary Conversions Qualifying for Tax Deferral

For purposes of an election to defer tax on gains, "involuntary conversion" is more broadly defined than "casualty loss." You have an involuntary conversion when your property is:

Damaged or destroyed by some outside force.

Stolen.

Seized, requisitioned, or condemned by a governmental authority. If you voluntarily sell land made useless to you by the condemnation of your adjacent land, the sale may also qualify as a conversion. Condemnation of property as unfit for human habitation does not qualify. Condemnation, as used by the tax law, refers to the taking of private property for public use, not to the condemnation of property for noncompliance with housing and health regulations. Similarly, a tax sale to pay delinquent taxes is not an involuntary conversion.

Sold under a threat of seizure, condemnation, or requisition. The threat must be made by an authority qualified to take property for public use. A sale following a threat of condemnation made by a government employee is a conversion if you reasonably believe he or she speaks with authority and could and would carry out the threat to have your property condemned. If you learn of the plan of an imminent condemnation from a newspaper or other news media, the IRS requires you to confirm the report from a government official before you act on the news.

Farmers. Farmers also have involuntary conversions when:

Land is sold within an irrigation project to meet the acreage limitations of the federal reclamation laws;

Cattle are destroyed by disease or sold because of disease; *or*

Draft, breeding, or dairy livestock is sold because of drought. The election to treat the sale as a conversion is limited to livestock sold over the number which would have been sold but for the drought. In some cases, livestock may be replaced with other farm property where there has been soil or other environmental contamination.

Should you elect to postpone gain? An election gives an immediate advantage: tax on gain is postponed and the funds that would have been spent to pay the tax may be used for other investments.

As a condition of deferring tax, the basis of the replacement property is fixed at the same cost basis as the converted property, unless your reinvestment exceeds the insurance proceeds. As long as the value of the replacement property does not decline, tax on the gain is finally incurred when the property is sold.

Consider whether postponement of gain at the expense of a reduced basis for property is advisable, compared to the tax consequences of reporting the gain in the year it is realized.

Special rules for federally declared disaster areas are discussed at ¶18.2.

EXAMPLE

Assume a rental building is destroyed by fire and a proper replacement is made. Assume that gain on the receipt of the insurance proceeds is taxable as capital gain. An election is generally not advisable if you have capital losses to offset the gain. However, even if you have no capital losses, you may still decide not to make the election and pay tax in order to fix, for purposes of depreciation, the basis of the new property at its purchase price, if the future depreciation deductions will offset income taxable at a higher rate than the current tax. If there is little or no difference between the two rates so that a net after-tax benefit from the depreciation would not arise, an election might be made solely to postpone the payment of tax.

¶18.20 How To Elect To Defer Tax

To defer tax on your gain, do not report the gain as income for the year it is realized. Attach to your return a statement giving details of the transaction, including computation of the gain and your intention to buy a replacement if you have not yet done so. *See* ¶18.21 for replacement periods and IRS notification requirements.

If your property is condemned and you are given similar property, no election is necessary. Postponement of tax on the gain is required. For example, the city condemns a store building and gives you another store building the value of which exceeds the cost basis of the old one; gain is not taxed.

Partnerships. The election to defer gain must be made at the partnership level. Individual partners may not make separate elections unless the partnership has terminated, with all partnership affairs wound up. Dissolution under state law is not a termination for tax purposes.

Nullifying Deferral Election on Amended Return

CAUTION

If you elect to defer tax on a gain, intending to buy replacement property, but you fail to make a replacement within the time limit, you must file an amended return for the year of the gain and pay the tax that you had elected to defer. You also must file an amended return and report the gain not eligible for deferral if you invest in property that does not qualify as a replacement, or which costs less than the amount realized from the involuntary conversion.

However, if you elect to defer and make a timely qualifying replacement, you may not change your mind and pay tax on the gain in order to obtain a higher basis (¶18.19) for the replacement property. The Tax Court has agreed with the IRS that the election to defer is irrevocable once a qualified replacement is made within the time limits. Similarly, once you report to the IRS (¶18.21) that a qualified replacement has been made, you may not substitute other replacement property, even if the replacement period has not yet expired.

¶18.21 Time Period for Buying Replacement Property

To defer tax, you generally must buy property similar or related in use (¶18.22) to the converted property within a fixed time period. The replacement period is either two, three, or four years:

1. A two-year replacement period applies for destroyed, damaged, or stolen property, whether used for business, investment, or personal purposes, but *see* ¶18.2 for the four-year period for principal residences in Presidentially declared disaster areas. A two-year period also applies to condemned property other than business or investment real estate eligible for the three-year replacement period.
2. A three-year replacement period applies for condemned business or investment real estate, excluding inventory. However, the two-year and not the three-year period applies if the condemned business or investment real estate is replaced by your acquiring control of a corporation that owns the replacement property.
3. A four-year replacement period applies for a principal residence damaged in a Presidentially declared disaster; *see* ¶18.2.

The two-year period for damaged, destroyed, and stolen property *starts* on the date the property was destroyed, damaged, or stolen, and *ends* two years after the end of the year in which you realize a gain.

For condemnations, the two-year or three-year (investment or non-inventory business real estate) replacement period *starts* on the earlier of (1) the date you receive notification of the condemnation threat, and (2) the date you dispose of the condemned property. The period *ends* two or three years after the end of the year in which gain on the condemnation is realized.

The four-year replacement period *starts* on the date the residence is involuntarily converted and *ends* four years after the end of the first taxable year in which any part of the gain is realized. *See* ¶18.2 for an example of the four-year replacement rule.

EXAMPLES

1. On January 10, 1996, a parcel of investment real estate is condemned; the parcel cost $15,000. On February 27, 1996, you receive a check for $23,500 from the state. You may defer the tax on the gain of $8,500 if you invest at least $23,500 in other real estate not later than December 31, 1999.
2. Business property was contaminated by dangerous chemicals, and after the Environmental Protection Agency ordered businesses and residents to relocate, the property was sold to the local government under a threat of condemnation. The owner was paid the full pre-contamination fair market value for the property. The owner wanted to defer gain under the three-year replacement rule for condemnations. However, the IRS said that part of the gain was deferrable under the two-year rule and part under the three-year rule. There were two conversions: (1) the contamination, subject to the two-year replacement rule; and (2) the later condemnation, subject to the three-year rule.
   To determine the amount eligible for deferral for each period, an allocation must be made between the proceeds allocable to the destruction of the property and the proceeds allocable to the condemnation.
   According to the IRS, the burden for making the allocation between the two conversions rests with the owner. The government's payments are allocable to the condemnation and, therefore, eligible for the three-year replacement rule, only to the extent of the post-contamination value. Practically speaking, it may be advisable to make the replacement within the two-year period, as it may be difficult to show the contaminated land had any value after the contamination.

Advance payment of award. Gain is realized in the year compensation for the converted property exceeds the basis of the converted property. An advance payment of an award which exceeds the adjusted basis of the property starts the running of the replacement period.

An award is treated as received in the year that it is made available to you without restrictions, even if you contest the amount.

Replacement before actual condemnation. You may make a replacement after a threat of condemnation. If you buy property before the actual threat, it will not qualify as a replacement even though you still own it at the time of the actual condemnation.

Extension of Time To Replace

A contract to buy replacement property within the time limits is not considered a qualified replacement. If you cannot replace property within the time required, ask your local District Director for additional time. Apply for an extension before the end of the period. If you apply for an extension within a reasonable time after the statutory period has run out, you must have a reasonable cause for the delay in asking for the extension.

Replacement by an estate. A person whose property was involuntarily converted may die before he or she makes a replacement. According to the IRS, his or her estate may not reinvest the proceeds within the allowed time and postpone tax on the gain. The Tax Court rejects the IRS position and has allowed tax deferral where the replacement was made by the deceased owner's estate. However, the Tax Court agreed with the IRS that a surviving spouse's investment in land did not defer tax on gain realized by her deceased husband on an involuntary conversion of his land. She had received his property as survivor of joint tenancy and could not, in making the investment, be considered as acting for his estate.

Giving IRS notice of replacement. If you have not bought replacement property by the time you file your return for the year of the involuntary conversion but you intend to do so, attach a statement to your return describing the conversion and the computation of gain, and state that you intend to make a timely replacement. Then, on the return for the year of replacement, attach a statement giving the details of your replacement property. This notice starts the running of the period of limitations for any tax on the gain. Failure to give notice keeps the period open. Similarly, a failure to give notice of an intention not to replace also keeps the period open. When you do not buy replacement property after making an election to postpone tax on the gain, file an amended return for the year in which gain was realized and pay the tax (if any) on the gain.

Assume you have a gain from an involuntary conversion and do not expect to reinvest the proceeds. You report the gain and pay the tax. In a later year, but within the prescribed time limits, you buy similar property. You may make an election to defer tax on the gain and file a claim for tax refund.

¶18.22 Types of Qualifying Replacement Property

Although exact duplication is not required, the replacement generally must be *similar or related in use* to the property that was involuntarily converted in order to defer tax. Where *real property* held for productive use in a business or for investment is converted through a *condemnation* or threat of condemnation, the replacement test is more liberal. A replacement merely has to be of a *like kind* to the converted property. Under the *like-kind* test, the replacement of improved property by unimproved property qualifies; *see* ¶6.1.

Under the *related-use* test, the replacement of unimproved land for improved land does not qualify. Under the *related-use* test, a replacement generally must be closely related in function to the destroyed property. For example, a condemned personal residence must be replaced with another personal residence. The replacement of a house rented to a tenant with a house used as a personal residence does not qualify for tax deferral; the new house is not being used for the same purpose as the condemned one. This functional test, however, is not strictly applied to conversions of rental property. Here, the role of the owner toward the properties, rather than the functional use of the buildings, is reviewed. If an owner held both properties as investments and offered similar services and took similar business risks in both, the replacement may qualify.

You may own several parcels of property, one of which is condemned. You may want to use the condemnation award to make improvements on the other land such as drainage and grading. The IRS generally will not accept the improvements as a qualified replacement. However, an appeals court has rejected the IRS approach in one case.

If it is not feasible to reinvest the proceeds from the conversion of livestock because of soil contamination or other environmental contamination, then other property (including real property) used for farming purposes is treated as similar or related and qualifies as replacement property.

Buying controlling interest in a corporation. The replacement test may be satisfied by purchasing a controlling interest (80%) in a corporation owning property that is similar or related in service to the converted property.

Business and investment property in a disaster area. Under a new law, the similar or related-use tests do not have to be met when replacing business or investment property damaged or destroyed in a Presidentially declared disaster area. You may make a qualified replacement by buying any tangible property held for business use. This new rule applies retroactively for disaster declarations made after December 31, 1994, in taxable years ending after that date.

¶18.23 Cost of Replacement Property Determines Postponed Gain

To fully defer tax, the cost of the replacement property must be equal to or exceed the *net proceeds* from the conversion. If replacement cost is less than the adjusted basis of the converted property, you report the entire gain. If replacement cost is less than the amount realized on the conversion but more than the basis of the converted property, the difference between the amount realized and the cost of the replacement is reported as gain; you may elect to

postpone tax on the balance of the gain. *See* Examples 1 – 3 at the bottom of this column.

Condemnation award. The award received from a state authority may be reduced by expenses of getting the award such as legal, engineering, and appraisal fees. The treatment of special assessments and severance damages received when part of your property is condemned is explained at ¶18.24. Payments made directly by the authority to your mortgagee may not be deducted from the gross award.

Do not include as part of the award interest paid on the award for delay in its payment; you report the interest as interest income. The IRS may treat as interest part of an award paid late, even though the award does not make any allocation for interest.

Relocation payments are not considered part of the condemnation award and are not treated as taxable income to the extent that they are spent for purposes of relocation; they increase basis of the newly acquired property.

Distinguish between insurance proceeds compensating you for loss of profits because of business interruption and those compensating you for the loss of property. Business interruption proceeds are fully taxed as ordinary income and may not be treated as proceeds of an involuntary conversion.

A single standard fire insurance policy may cover several assets. Assume a fire occurs, and in a settlement the proceeds are allocated to each destroyed item according to its fair market value before the fire. In comparing the allocated proceeds to the tax basis of each item, you find that on some items, you have realized a gain; that is, the proceeds exceed basis. On the other items, you have a loss; the proceeds are less than basis. According to the IRS, you may elect to defer tax on the gain items by buying replacement property. You do not treat the proceeds paid under the single policy as a unit, but as separate payments made for each covered item.

EXAMPLES

1. The cost basis of your four-family apartment house is $175,000. It is condemned to make way for a thruway. The net award from the state is $200,000. Your gain is $25,000. If you buy a similar apartment house for $175,000 or less, you report the entire $25,000 gain.
2. Using the same figures as in Example 1, except that you buy an apartment house for $185,000. Of the gain of $25,000, you report $15,000 as taxable gain ($200,000 – $185,000). You may elect to postpone the tax on the balance of the gain, or $10,000.
3. Using the same figures as in Example 1, but you buy an apartment house for $200,000. You may elect to postpone tax on the entire gain because you have invested all of the award in replacement property.

¶18.24 Special Assessments and Severance Damages

When only part of a property parcel is *condemned* for a public improvement, the condemning authority may:

1. Levy a special assessment against the remaining property, claiming that it is benefited by the improvement. The authority usually deducts the assessment from the condemnation award.
2. Grant an award for severance damages if the condemnation of part of your property causes a loss in value or damage to the remaining property which you keep.

Special assessments reduce the amount of the gross condemnation award. If they exceed the award, the excess is added to the basis of the property. An assessment levied after the award is made may not be deducted from the award.

EXAMPLE

Two acres of a 10-acre tract are condemned for a new highway. The adjusted basis of the land is $30,000, or $3,000 per acre. The condemnation award is $10,000; the special assessment against the remaining eight acres is $2,500. The net gain on the condemnation is $1,500:

Condemnation award		$10,000
Less:		
Basis of two condemned acres	$6,000	
Special assessment	2,500	8,500
Net gain		$1,500

When both the condemnation award and severance damages are received, the condemnation is treated as two separate involuntary conversions: (1) A conversion of the condemned land. Here, the condemnation award is applied against the basis of the condemned land to determine gain or loss on its conversion. And (2) a conversion of part of the remaining land in the sense that its utility has been reduced by condemnation, for which severance damages are paid.

Net severance damages reduce the basis of the retained property. Net severance damages are the total severance damages, reduced by expenses in obtaining the damages and by any special assessment withheld from the condemnation award. If the damages exceed basis, gain is realized. Tax may be deferred on the gain through the purchase of replacement property under the "similar or related in use test" at ¶18.22, such as adjacent land or restoration of the property to its original condition.

Allocating the proceeds between the condemnation award and severance damages will either reduce the gain or increase the loss realized on the condemned land. The IRS will allow such a division

only when the condemnation authority specifically identifies part of the award as severance damage in the contract or in an itemized statement or closing sheet. The Tax Court, however, has allowed an allocation in the absence of earmarking where the state considered severance damages, and the value of the condemned land was small in comparison to the damages suffered by the remaining property. To avoid a dispute with the IRS, make sure the authority makes this breakdown. Without such identification, the IRS will treat the entire proceeds as consideration for the condemned property.

¶18.25 Reporting Gains from Casualties

If an involuntary conversion was the result of a *theft* or *casualty*, you have to prepare Form 4684. To report net gains, Form 4684 will direct you to Form 1040, Schedule D, or Form 4797, depending on the type of property involved. Generally, use of Form 4797 reflects the netting requirements for involuntary conversions of business, rental, or royalty property under Section 1231; *see* ¶44.8.

If the conversion occurred because of a *condemnation*, you use Form 4797 and/or Schedule D depending on the holding period and your purpose in holding the property.

Condemnations of personal-use property are reported in Schedule D: if held for less than a year, in Part I; if held for more than a year, in Part II. Losses on the condemnation of personal-use property are not deductible.

Condemnations of business or investment property held for more than a year are reported in Part I, Form 4797. Investment property held for less than a year is reported in Part I, Schedule D; business and rental property held for less than a year is reported in Part II, Form 4797.